

June 9, 2003

**VIA HAND DELIVERY**

Hon. Kristi Izzo, Esq., Secretary  
New Jersey Board of Public Utilities  
Two Gateway Center  
Newark, New Jersey 07102

**RE: I/M/O the Audits of the Competitive Service Offerings of New  
Jersey's Electric and Gas Utilities Pursuant to the Electric Discount  
and Energy Competition Act, N.J.S.A. 48:3-56 and 48:3-58  
South Jersey Gas Company  
BPU Dkt Nos. AA02020094 and GA02020101**

Dear Secretary Izzo:

Please accept for filing an original and ten copies of the Division of the Ratepayer Advocate's ("Ratepayer Advocate") Redacted Comments regarding the above referenced matter.

Enclosed is one additional copy. Please date stamp the copy as "filed" and return it to the courier. Thank you for your consideration and attention in this matter.

**INTRODUCTION**

These comments are in response to the Competitive Services Audit performed by Overland Consulting and the related comments submitted on March 20, 2003 by South Jersey Gas Company ("SJG" or "Company").

On March 14, 2003, Overland Consulting of Overland Park, Kansas ("Overland"), released its "Audit of the Competitive Service Offerings of South Jersey Gas Company,

Docket #GA02020101” (hereinafter referred to as the “Audit Report”). The underlying audit performed by Overland was conducted pursuant to *N.J.S.A.* 48:3-55, 48:3-56 and 48:3-58, which requires the New Jersey Board of Public Utilities (“Board” or “BPU”) to secure independent consultants to conduct audits of the competitive business segments of all New Jersey electric and gas utilities for compliance with the Board’s Affiliate Standards.<sup>1</sup>

Following release of the Audit Report, on March 20, 2003, SJG, through a letter from David A. Kindlick, SJG’s Executive Vice President and Chief Financial Officer, submitted comments to the Board on each audit recommendation. Mr. Kindlick’s letter also discussed what SJG considers the three “major issues” raised in the audit. The major issues concern: (1) general problems with SJG’s cost allocation and accounting systems; (2) Millennium Account Services, LLC; and (3) the appliance service business spin-off.

Pursuant to a decision by the Board at its April 9, 2003 agenda meeting, confirmed by a letter dated April 23, 2003 from Walter P. Szymanki, Director, Division of Audits, to Seema Singh, Ratepayer Advocate, comments regarding the gas company audits are due June 9, 2003. Following are the Ratepayer Advocate’s comments. Our comments begin with a discussion of the major issues. Following that discussion, we comment on the audit recommendation.

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<sup>1</sup> The “Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements,” *N.J.A.C.* 14:4-5.1 *et seq.* (“Affiliate Standards”)

## **MAJOR ISSUES**

### **A. COST ALLOCATION**

The Overland Audit raises issues of concern to the Ratepayer Advocate. Our concern stems not so much from the auditor's findings, but rather from how SJG's affiliate relationships and transactions could not even be properly evaluated. The Audit Report documents numerous incidences where Overland simply was unable to thoroughly examine affiliate relationships and transactions because appropriate data and records are not kept or cannot be extracted in a usable form.<sup>2</sup>

Overland described the objectives of the audit (on page 1-1 of the Audit Report) as to determine:

- Whether there is a strict separation or allocation of utility revenues, costs, asset, risks and functions from those of its competitive service segments.
- Whether the degree of separation is reasonable under the BPU's Affiliate Standards.
- Whether there is cross-subsidization between the utility and competitive service segments.
- The impact on ratepayers of using utility assets to provide competitive services.
- The impact of competitive services on utility workers.
- The impact of utility practices on the market for competitive services.
- Whether recommendations from the previous audit have been fully implemented.

The Audit Report can be evaluated in terms of how well Overland was able to meet these objectives. After carefully reviewing both the Audit Report and SJG's written responses to Overland's discovery questions, it can be reasonably concluded that in nearly every

instance, Overland was not successful in meeting the audit objective. These failures were not the result of negligence or incompetence on Overland's part. The failures are directly attributable to SJG's antiquated accounting system, to South Jersey Industry's ("SJI")/SJG's antiquated organizational structure, and to the duplicity of SJI's Cost Allocation Manual.

Overland summarized the deficiencies in SJG's present accounting system on pages 3-4 and 3-5 of its Audit Report as follows:

SJI and SJG did not employ a management accounting system that segregated costs by department, responsibility center, or cost center during the audit period (except in rare instances). Executive management attributed this deficiency to the outdated accounting systems now used by SJG. *As a result, we were not able to quantify the costs associated with each significant shared corporate service (e.g., human resources, accounting, etc.) and neither could SJG's accounting department.* Lack of such a system may be the primary reason that SJI and SJG did not pool common costs for allocation purposes but, instead, allocated costs primarily on a transaction-by-transaction basis.

SJG's accounting system was developed in the mid-1970's with the assistance of IBM. We requested general ledger detail in electronic format. However, in response to this data request, SJG provided two different types of electronic files. The first files provided were the equivalent of a 'snapshot' of the data in text format. When we explained that this format was not conducive to any meaningful analysis, SJG provided a supplemental response in spreadsheet format but in such a disorganized manner that it was totally unusable (for instance, a number such as '1,500,075' was shown in three different amounts – '1' and '500' and '075'). On January 10, 2003, we received a follow-up response from SJG that said:

Have tried several times to provide requested data electronically; data is not available without substantial time and effort to create electronic files; request is too burdensome with which to comply.

We did not anticipate that a request for such basic information could not be accommodated by SJG. Time constraints did not permit us to re-format the data. *Without the ability to sort and summarize data from SJG's*

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<sup>2</sup> Audit Report, 3-1, 3-3, 3-4, 3,5, 3-6,

*general ledger, we were severely restricted in our ability to analyze the allocations of hundreds if not thousands of individual transactions occurring during the audit period. (Emphasis supplied; footnotes omitted.)*

SJG comments that it is in the process of implementing a new accounting system. SJG concedes that implementing a new system “...changes nothing during the audit period...”<sup>3</sup> SJG asks us all to share its expectation that “the implementation of the new accounting system should mitigate any related legitimate concerns raised during the audit.”<sup>4</sup>

However, merely implementing a new accounting system will not resolve the serious and pervasive cost allocation problems uncovered in Overland’s audit. One must hope that the new accounting system will provide an effective tool to management and to independent auditors to properly record and track attributable costs among and between affiliates. But, if the organization is not properly structured, if there are inadequate safeguards preventing abuses before costs are entered into the accounting system, or if improper allocation procedures are programmed into the accounting system, the new accounting system alone will not resolve SJG’s cost allocation problems. SJG’s cost allocation problems extend far beyond its antiquated accounting system.

Overland and the Ratepayer Advocate both agree that SJI’s/SJG’s present organizational structure is a leading contributor to a significant cost allocation problem among SJI’s corporate affiliates. As it now stands, shared corporate services costs originate predominately, but not exclusively, at the regulated utility. Relatively few administrative functions are carried out by SJI, as shown on Table 3-1 on page 3-5 of the Audit Report. This unusual organizational structure is the antithesis of the separate service company concept that has been adopted by utilities throughout the country,

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<sup>3</sup> Kindlick letter, page 2.

<sup>4</sup> *Ibid.*

including several in New Jersey. In fact, the auditors in SJG's first competitive services audit recommended that the Board require SJI/SJG to establish a separate service company.

While there are convincing arguments that recommend SJI/SJG establishing a separate service company, the Ratepayer Advocate does not wish to turn the present audit into a referendum for doing so. Rather, if SJG is to continue providing shared corporate services, it is imperative that SJG be required to establish appropriate procedures and costing practices that emulate a separate service company function or division(s) within SJG that is functionally separate from SJG's utility functions.

As it presently stands, the combination of having SJG officers and employees providing shared services plus their use of exception time reporting, which is *not* permitted under SJI's CAM<sup>5</sup>, results in costs defaulting to SJG, rather than being fairly allocated among appropriate affiliates.<sup>6</sup>

Shared services functions housed in SJG should be functionally separated from SJG's utility operations by creating a shared services department(s) and cost responsibility centers. No costs from the shared services department(s) should automatically default to SJG. Instead, SJG should be required to execute a shared services agreement with each affiliate. These agreements should specify the shared service being provided and the basis for charges to affiliates for the shared services. The Ratepayer Advocate expects that the majority of shared services costs can be directly billed to the affiliate requiring the services. In some instances, however, direct billing will not be possible. In such instances, the shared services agreements should specify the

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<sup>5</sup> See Audit Report, page 3-6.

<sup>6</sup> See Audit Report, page 3-1.

basis of cost allocation or assignment for each separate shared service, which should rely on cost-causative principles to the greatest extent possible. For example, shared accounting services costs could be billed to affiliates based on the number of entries, accounts, or transactions required for each entity. Information technology could be billed based on usage time or the number of transactions. Other indicators of relative usage or cost responsibility can be identified for other shared services. Specifying the basis for cost assignment in a shared services agreement will negate the need for SJG to bill on a transaction-by-transaction basis, as it does now.<sup>7</sup> The important point is that all shared services costs should be appropriately identified and billed using known and consistent costing principles. No costs should *default* to SJG. SJG should be charged for shared services costs *only* to the extent that, and *in the precise amount* that, it actually requires the service.

Establishing a shared service department and cost responsibility centers within SJG will likely require that the current CAM be completely overhauled. In fact, Overland is already very critical of SJI's current CAM. On page 3-1 of the Audit Report Overland states:

SJI's cost allocation process was developed from a bottom-up perspective. Most allocations of costs were performed on a transaction-by-transaction basis. Numerous allocations documented in the CAM did not have adequate support. SJG could not provide basic information including, but not limited to, employee headcount information from prior years and useable electronic general ledger data. Neither SJI nor SJG employed a management accounting system that segregated costs by department, responsibility center or cost center. All of these factors hindered in our ability to review the cost allocation process employed by SJI and, more importantly, to quantify any mis-allocations of costs.

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<sup>7</sup> Audit Report, page 3-3.

Overland's criticism of SJI's CAM continued and grew more pointed where on pages 3-3 and 3-4 of the Audit Report Overland states:

In response to our request for the SJI/SJG corporate cost allocation model and underlying support, SJG management referenced the SJI CAM. However, in many cases, the CAM did not provide the information necessary to determine the sources of the summarized data or to assess the overall reasonableness of the calculations. When we made attempts to obtain this information, SJG was unable to respond in a timely manner. (Footnotes omitted.)

### **Recommendation**

In light of the significant deficiencies noted in the Audit Report relating to cost allocation of shared services, and in conjunction with SJG implementing a new accounting system, the Ratepayer Advocate recommends that the Board convene a separate proceeding to address restructuring shared services being provided by SJG into separate departments and cost responsibility centers and to address overhauling SJI's current CAM. Without these steps, the next competitive services audit will turn out exactly like Overland's audit, *i.e.*, limited to a conceptual overview of how things should be done, rather than actually testing and measuring SJG's compliance with the Affiliate Standards.

### **MILLENNIUM ACCOUNT SERVICES ("MILLENIUM" OR "MAS")**

In 1999, Atlantic City Electric Company (a subsidiary of Conectiv) ("ACE") and SJI formed Millennium Account Services, LLC, a joint venture limited liability company, to provide meter reading services in southern New Jersey.

SJG's major disagreement with the Audit Report is SJG's contention that Millennium is not a Related Competitive Business Segment ("RCBS") of a gas public utility holding company under the Affiliate Standards. In fact, SJG attached to its



comments a legal opinion that concludes: (1) Millennium is not a RCBS; (2) the Board has never determined that meter reading is a competitive service; and (3) the Board lacks jurisdiction to establish prices for Millennium.<sup>8</sup> Moreover, SJG believes that the appropriate forum to evaluate SJG's meter reading expenses is in a rate case, not a competitive services audit and that the appropriate standard by which SJG's meter reading expenses are to be judged is "fair market value."<sup>9</sup> SJG rejects the notion that Millennium's rates should be evaluated on a cost or rate of return basis.

The Ratepayer Advocate disagrees with SJG's conclusion that the Board has no jurisdiction over its relationship with Millennium. Further, the Ratepayer Advocate asserts that any potential affiliate relationship that may affect a utility, and therefore its ratepayers, is subject to Board jurisdiction. With any transaction between an affiliate and a utility there is an opportunity for abuse of that relationship. The Legislature gave the Board broad jurisdiction to examine the utilities and their contracts. The spirit of the Affiliate Standards combines this broad mandate with the recognition that there is not one type of relationship that can affect a utility. It is antithetical to the spirit of the Affiliate Standards to attempt in any way to prevent the Board from examining relationships that affect a utility and its customers.

Likewise, the Ratepayer Advocate also believes that there are particular legal mandates delineated throughout the statutes and the Affiliate Standards themselves that specify the requirement of Board oversight and review.

The Board has a broad mandate to supervise and regulate public utilities. *N.J.S.A.* 48:2-13. The Board also has jurisdiction to review and determine the reasonableness of

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<sup>8</sup> Kindlick letter, page 1.

<sup>9</sup> *Ibid.*

service contracts entered into by utilities and affiliates pursuant to *N.J.S.A. 48:3-7.1*. See *I/M/O the Petition of United Water New Jersey Inc. for Approval of a Service Contract with United Water Mid-Atlantic Inc., an Affiliate Company of the Petitioner*, BPU Docket No. WE97050345, February 4, 1998; *I/M/O the Request by Middlesex Water Company for Approval of the Service Agreement between Middlesex Water Company and Utility Service Affiliates, Inc.*, BPU Docket No. WE95050250, November 22, 1995.

In the legal opinion provided to SJG by its counsel,<sup>10</sup> its counsel opines that Millenium is not an RCBS because the Affiliate Standard regulations are only applicable to an affiliate that provides or offers competitive services to retail customers in New Jersey, referring to *N.J.A.C. 14:4-5.1(a)1*. This, however, is not correct.

The Company argues that since SJI, not SJG, is the “owner” of Millenium, the Board has no jurisdiction over Millenium. This is untrue for several reasons. Millenium was formed with the express purpose of serving the SJG (and ACE) service territory, not to perform any service for SJI. The SJI representatives on the Millenium Executive Board are both officers of SJG.<sup>11</sup> It appears clear that only SJG has any operational contact with Millenium. Millenium’s services are provided to the utility, SJG sells the service, invoices the customers, and payments are made from the utility to Millenium.<sup>12</sup> The SJG customers are the ones who are affected by Millenium’s operation.

*N.J.A.C. 14:4-5.1(a)2* is the applicable scope standard:

*N.J.A.C. 14:4-5.6* sets forth standards of conduct applicable to electric and/or gas public utilities and the related competitive business segments of each electric public utility and gas utility, as well as the transactions, interactions and relations between an

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<sup>10</sup> Letter from Ira G. Megdal, Esq. to David Kindlick, SJG, and Richard Walker, Esq., SJI, dated March 19, 2003.

<sup>11</sup> Audit Report, 5-3.

<sup>12</sup> *Supra* note 10.

electric and/or gas public utility and a related competitive business segment of and electric and/or gas public utility...

There is no requirement that the scope of the regulation be limited to services for retail customers. Likewise, the Electric Discount and Energy Competition Act (“EDECA”) contains no mandate that only retail competitive services are subject to regulation. EDECA defines “competitive services” as “any service offered by...a gas public utility that the board determines to be competitive pursuant to section 8 or section 10 of this act or that is not regulated by the board.” *N.J.S.A.* 48:3-51.

Even if the Board were to determine that the regulation to which the Company refers [*N.J.A.C.* 14:4-5.1(a)1] is the correct standard, the regulation is still applicable to Millenium. The regulation to which SJG refers does not require that the RCBS *sell* the service to the retail customers, only that it *provide* the service to the retail customers. Millenium does indeed “provide” service to retail customers through intermediary SJG. Even SJG’s legal opinion states that “[t]he end-users of the meter reading business are, of course, the residential, commercial and industrial customers of ACE and South Jersey. These customers purchase this service from South Jersey and ACE at retail, as part of a bundled utility bill..”<sup>13</sup> Similarly, the legal opinion also states that “[t]he ultimate consumers of meter reading services are the customers of South Jersey and ACE.”<sup>14</sup>

*N.J.A.C.* 14:4-5.6(a)(2) states that “a public utility holding company may offer a competitive service to retail customers of a gas public utility that is owned by the holding company, but only through a related business segment of the holding company that is not a related business segment of the gas public utility...” As defined in *N.J.A.C.* 14:4-5.2, a “competitive service” is “any services, goods, or products offered by...a gas public utility

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<sup>13</sup> *Supra* note 10.

that the Board has already determined or that the Board shall in the future determine to be competitive pursuant to section 8 or section 10 of the Act or that is not regulated by the Board.” This language mimics that found in EDECA section 10, *N.J.S.A. 48:3-58(b)(1)*. Further, according to the regulatory definitions, the only difference between a related competitive business segment of a gas public utility and that of a public utility holding company is that the RCBS of a public utility holding company may not include an RCBS of a gas public utility.

The Company also claims that metering is not a competitive service because the Board has not yet determined that it is. In the same regulation, however, metering is included in a list of competitive services. *N.J.A.C. 14:4-5.6(b)*, which is actually a restriction on the services that gas and electric utilities can offer, *N.J.A.C. 14:4-5.6(b)1* lists “[m]etering, billing or administrative services that are deemed competitive by the Board pursuant to *N.J.S.A. 48:3-56*.” The Company argues that *all* these services require Board determination pursuant to this statute. However, the construction of the regulation does not suggest that this is the case. Only “administrative services” is modified by “deemed competitive by the Board...” “Metering” and “billing” stand alone, and therefore have already been determined to be competitive.

Accordingly, the regulations set forth at *N.J.A.C. 14:4-5.6* are specific as to the ratemaking treatment that should occur with regard to an RCBS:

(r) The revenues received by an electric and/or gas public utility or its related competitive business segment(s) for the provision of a competitive product and/or service shall be treated in the following manner:

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4. For gas public utilities, the total margins shall be treated above- the-line for ratemaking purposes

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<sup>14</sup> *Supra* note 10.

and credited to ratepayers in a manner to be determined by the Board.

- (s) Revenues received by an electric and/or gas public utility as the result of a transfer of services or a transfer, lease or rental of assets to an affiliate shall be recorded in respective competitive service revenue account and credited to ratepayers in a manner to be determined by the Board.
- (t) Each electric and/or gas public utility is required to file a public tariff with the Board for each competitive product and/or service it or its related competitive business segment offers in the State, setting forth pricing terms and other terms and conditions associated with these competitive products and/or services.

Finally, EDECA gives a broad mandate to the Board to prevent competitive mischief. At *N.J.S.A. 48:3-58(j)*, EDECA states that:

Nothing in this act shall limit the authority of the board, pursuant Title 48 of the Revised Statutes, to ensure that gas public utilities do not make or impose unjust preferences, discriminations, or classifications for any services provided to customers.

Concurrent with Overland's audit of SJG's competitive services, a different independent consultant, The Liberty Consulting Group of Quentín, Pennsylvania ("Liberty"), was engaged by the Board to audit ACE's competitive services. ACE is a joint partner with SJI in the ownership of Millennium. After carefully reviewing ACE's relationship with Millennium, Liberty concluded, as did Overland, that Millennium indeed was a RCBS, finding as follows:

3. Conclusions

a. **Millennium is an RCBS of ACE's holding company.**

Millennium provides services to customer who can be construed as end users and therefore retail customers of meter reading services, which is a competitive service.<sup>15</sup>

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<sup>15</sup> "Audit of the Competitive Service Offerings of Atlantic City Electric Company d/b/a Conectiv Delivery Power, Docket No. EA02020095 ("Liberty Audit Report), page 14.

Prior to our discussing the Board's jurisdiction to exercise regulatory control over the prices paid by SJG for meter reading services, the Ratepayer Advocate will first discuss what is wrong with the present relationship between SJG and Millennium. After carefully reviewing the transfer price between Millennium, Overland concluded as follows:

In considering whether Affiliate Standards apply to Millennium, the BPU should take notice that Millennium is charging SJG based on transfer prices that appear to exceed both its fully allocated cost of service as well as a market-comparable price evidenced by meter reading bids submitted to SJG by two other companies.<sup>16</sup>

Further, Overland found:

Affiliate Standards limit the price Millennium is permitted to charge SJG to the lower of fully allocated cost or market. Millennium's prices exceeded both fully allocated costs as well as "market-comparable" prices evidenced in bids submitted by two other companies. Analysis indicates that fully-allocated cost was the maximum price Millennium was permitted to charge SJG under Affiliate Standards. Based on the amounts by which Millennium's prices exceeded fully allocated cost, we estimate SJG cross-subsidized Millennium by approximately \$443,000 in 2001 and by approximately \$587,000 in 2002.<sup>17</sup>

It is also instructive for the Board to review Liberty's findings regarding Millennium's pricing/cost relationship with ACE and its findings regarding outsourcing meter reading services in general. Those findings are as follows:

- c. Millennium pricing makes meter reading available to ACE at less cost than would be required for ACE to perform the service internally and alone, but at greater cost than would be the case in a cost-based joint venture with the other utility involved.

Millennium reads the meters of ACE's customers at a lower cost than when ACE's employees read the meters. Meter-reading service quality, as shown by fewer missed meter reads, is also higher. The amount of margin available to the Millennium owners indicates that the charges exceed the

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<sup>16</sup> Audit Report, page 5-1.

<sup>17</sup> Audit Report, page 5-2.

average cost of the two utilities. The asset base required for this service is not significant enough to consume the margin.

- d. Renewal of the contract with Millennium violated subsection 14:4-5.3(b)(2), which precludes RCBS/utility transactions not subject to competitive procurement.

The first Millennium contract came before EDECA was enacted. When ACE renewed the agreement with MAS in 2002, however, it did so without soliciting bids from other prospective providers.

- f. Despite the customer benefits, the formation and operation of Millennium are troublesome under the Standards.

There is a broader issue than the violation of subsection 14:4-5.3(b)(2). That issue is whether it is appropriate for a utility, without prior approval from the BPU, to outsource a traditional utility function on what is, in effect, a permanent basis, to a non-utility affiliate. Doing so in the manner that has occurred here has the effect of turning a cost center into a profit center. Even where the change produces net savings over a “do nothing” alternative, it begs the question of whether a utility has failed to undertake the best means of serving customers, rather than one that is merely better than the historical option used. Liberty believes that the creation of additional profit opportunities by hiving off core utility functions raises questions that regulators should participate in answering before the fact.

Perhaps, for example, some sharing of the cost-savings margin is appropriate. Sharing can serve to give utilities an incentive to seek creative ways of joining forces and it can provide a proper means of compensating companies for any added risks involved in those new ways. Even so, it is difficult to see the public merit in not giving the BPU an opportunity in advance to consider what level of sharing between customers and investors would be appropriate to provide sufficient incentives to keep customer costs at a minimum. Currently, the existence of comprehensive Standards in New Jersey underscores the State’s interest in prior review and approval of transactions with RCBSs and in assuring that certain administrative processes and requirements are followed with respect to entry into agreements and their price and other terms.

The MAS profit makes no contribution to offsetting revenues required from ratepayers. In contrast, it seems clear that Millennium’s pricing is lower than ACE’s fully-allocated costs. In the final analysis, however, if costs are the proper determinant, then the correct “costs” to examine are Millennium’s fully-allocated costs, which are lower than ACE’s.

The other available pricing option is market price. ACE does not pay the market price of the service, and none is available for ready reference because any meter-reading contract would have to reflect the unique characteristics of the utility's meter types, configurations, and geographic distribution. If Millennium had been one of several bidders for the business of providing meter-reading services to ACE and had won in a competition, the pricing of MAS's services and the profit that the company makes could be benchmarked against a verifiable market price. As a result, no market price was established through bidding. In fact, had there been bidding, it does not seem likely that the bids would have been structured at the start of a discount from the company's cost of meter reading, or that a renewal would be based on the last cost with an inflation adjustment. Instead, true competition would have caused the winner to offer a price that was closer to its costs of reading the meters, because it would be competing with other contractors, all of whom would understand the risk/reward relationship at issue. As SJI put it in its Form 10-K filing with the SEC:

An excellent example of a low-risk, high-return opportunity is SJI's joint venture with Conectiv Solutions, LLC – Millennium Account Services, LLC. 2001 marked the third straight year of improved profitability for the company with the partners sharing pre-tax earnings of \$1.1 million.<sup>18</sup>

In light of the concerns surrounding Millennium, Liberty recommended the following actions to the Board:

2. In combination with SJG, solicit bids for meter-reading services being provided by Millennium; if another vendor offers lower costs, then ACE should change contractors.

One approach is to take steps to make sure that ACE's customers are incurring the market price for contract meter reading. Doing so would reduce the likelihood that ACE is subsidizing MAS. The Board can have the results of a competition that will test the price in less than a year.

ACE and SJG can submit a plan that will show how they will put their meter reading up for bids, with the prospect that another party could take over from MAS. ACE and SJG must do this together or it will not work. The Board can monitor the process from development of a request for proposals through the issuance of a new contract, or the Board can have the companies put the business of reading their meters up for bid and examine the results after the procurement process is done, perhaps in the next biennial EDECA audit.

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<sup>18</sup> Liberty Audit, pages 14-16.



Whatever the Board chooses, the primary concern should be that ACE and SJG use a process that give prospective bidders reasonable assurance that they have a fair chance of taking over MAS's position as the contractor. If MAS is one bidder among several and has the lowest evaluated price then the Board will have taken steps to ensure that the relationship between MAS and ACE does not raise the question of whether ACE is subsidizing MAS.

ACE has the right to terminate its contract with Millennium with 90 days notice to Millennium. If ACE terminates the contract then it must pay MAS the sum of \$3,022 a month for the remaining term of the agreement, in exchange ACE will own certain equipment. If the Board were to determine that this term of the contract should be honored in the circumstance that another meter-reading vendor offered a lower price to read the meters of SJG and ACE, then the \$3,022 monthly charge should be included in the companies' and Board's decision on whether the utilities should change vendors. If the difference between the lowest bid from prospective vendors and MAS's pricing is \$36 thousand a year, then there should be no change in provider. This is unlikely to be the case, however, especially if MAS decides to submit a bid to ACE and SJG.<sup>19</sup>

Abundant case law exists in which regulatory bodies have limited the prices paid by utilities for goods and services provided by affiliates. Here in New Jersey, both *I/M/O the Petition of United Water New Jersey Inc. for Approval of a Service Contract with United Water Mid-Atlantic Inc., an Affiliate Company of the Petitioner*, BPU Docket No. WE97050345, February 4, 1998; *I/M/O the Request by Middlesex Water Company for Approval of the Service Agreement between Middlesex Water Company and Utility Service Affiliates, Inc.*, BPU Docket No. WE95050250, November 22, 1995 are decisions in which the Board determined the reasonableness of a service agreement. In each case, the Board limited the prices paid by the utility to actual costs incurred.

There is also another troubling aspect of Millennium's operation that was not discussed in either Overland's audit of SJG or in Liberty's audit of ACE, even though it was included as part of Overland's audit objectives. One of Overland's objectives was to

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<sup>19</sup> Liberty Audit, page 15.

examine the impact of competitive services on utility workers. This objective seems to have been overlooked when considering Millennium's operations.

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**Recommendation**

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Whether or not it is ultimately deemed by the BPU to be an RCBS, the Millennium dilemma is problematic. Meeting a restrictive interpretation of the Affiliate Standards in this case does not make what is happening with Millennium any more acceptable. Nor does it make it appropriate regulatory policy. Overland hit the regulatory policy issue squarely when it stated: “It should be noted that relationships and transactions between SJG and affiliates can affect SJG and its ratepayers regardless of whether the affiliate is deemed to be subject to Affiliate Standards.”<sup>20</sup>

The Ratepayer Advocate agrees with Liberty’s recommendation to have ACE and SJG solicit competitive bids for meter reading services. It is only through competitive bids that a reliable measure of the market price for meter reading services can be determined. If there are not sufficient competitive bids for the utilities to ascertain a reliable measure of the market price, such services, whether provided by Millennium or bringing the service back within the utility, should be based on the actual cost of the service, at the utility’s allowed rate of return. If the Board determines that it does not have sufficient information to adopt for SJG Liberty’s recommendations relating to Millennium, the Ratepayer Advocate considers the Millennium issue to be so significant so as to warrant a special investigation.

#### **APPLIANCE SERVICE BUSINESS (“ASB”) SPIN-OFF**

SJG’s comments correctly state that it currently has on file with the BPU a petition to spin-off its ASB to a separate but affiliated entity. From there, SJG arrives at

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<sup>20</sup> Audit Report, page 1-4.

the unsupported conclusion that all of the audit issues would be resolved once the ASB is separated from SJG. SJG then opines that Overland “should have concluded that separating the ASB from the gas utility is an appropriate step and would advance the Board’s deregulation policy and eliminates any issues with the Affiliate Standards.”<sup>21</sup>

Overland is not in a position to recommend the transfer of SJG’s ASB. What Overland is quite capable of reviewing, however, is SJG’s compliance with Affiliate Standards as the ASB is currently structured. Unless and until the Board acts to approve the ASB transfer, SJG must comply with the relevant Affiliate Standards. Such compliance should continue to be noted in the auditors’ reports.

In the following section, the Ratepayer Advocate provides comments on the individual recommendations offered in Overland’s Audit Report and SJG’s comments thereto.

### **SPECIFIC COMMENTS**

Please note that the following recommendations and responses paraphrase both Overland and SJG and should not be considered to be direct quotes.

#### **Audit Recommendations**

##### **A. Affiliate Transactions Documentation and Internal Control**

###### ***Overland’s Recommendation***

- 1. Create separate inter-company payable and receivable accounts for each SJI subsidiary and joint venture and record all inter-company transactions in these accounts.**

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<sup>21</sup> Kindlick letter, page 2.

***SJG's Response***

SJG agrees with this recommendation.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate agrees with this recommendation and urges the Board that it be adopted.

***Overland's Recommendation***

- 2. Develop a single monthly inter-company invoice summarizing all charges from one affiliate to another.**

***SJG's Response***

SJG agrees with this recommendation.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate agrees with this recommendation and urges the Board that it be adopted.

***Overland's Recommendation***

- 3. Since the same person currently holds both positions, delineate the job responsibilities of the Assistant Vice President – Gas Supply & Off-System Sales of SJG and Vice President of SJRG in writing. Document how potential conflicts of interest in these positions will be avoided when the two companies transact business with each other.**

***SJG's Response***

SJG agrees with this recommendation.

### ***Ratepayer Advocate's Comments***

It is not clear why Overland recommended a simple paper delineation of the job responsibilities rather than recommending that different people staff these two positions. SJG and SJRG have significant transactions with each other. While SJRG is not an RCBS, its transactions with SJG create a real, not just a potential, conflict of interest. To avoid any real or potential conflicts of interest, there should be no interlocking directors or officers between SJG and SJRG.

Therefore, the Ratepayer Advocate recommends that these positions not be held by the same person.

### ***Overland's Recommendation***

- 4. Adjust the officer appointments and/or board memberships of SJG, Millennium, and other subsidiaries to comply with Affiliate Standards or obtain permission for variances from the BPU.**

### ***SJG's Response***

SJG disagrees with this recommendation, as SJI believe that Millennium is not a RCBS and the Affiliate Standards do not apply.

### ***Ratepayer Advocate's Comments***

As previously noted, the Ratepayer Advocate strongly disagrees with SJG's conclusion that Millennium is not a RCBS. The Ratepayer Advocate recommends that the Board apply full force and effect of Affiliate Standards to Millennium and other subsidiaries including the requirement that there be no interlocking directors or officers between SJG and RCBSs.

***Overland's Recommendation***

- 5. Resubmit the SJG Compliance Plan after incorporating the findings and conclusions of this report and file on an annual basis thereafter. Summarize the changes in the Compliance Plan at the beginning of the document for ease of comparison.**

***SJG's Response***

SJG agrees with this recommendation.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate agrees with this recommendation and urges the Board that it be adopted. Further, the Ratepayer Advocate recommends that the Board establish a specified deadline for SJG to file its initial Compliance Report and that SJG be required to provide a copy of its Compliance Report to the Ratepayer Advocate.

**B. Cost Allocations**

***Overland's Recommendation***

- 1. Adopt an attributable cost basis for allocating the common costs of SJI departments and SJG departments providing shared services. Retain supporting workpapers for these allocations.**

***SJG's Response***

SJG agrees in principle with this recommendation. SJG also agrees to retain workpapers supporting its cost allocation methods. SJI and affiliates believe, however, that their cost allocation methods are reasonable and New Jersey Tax law supports that its three-factor approach. SJG also states that the new

accounting system, which it currently is in the process of implementing, will allow the Company to capture additional data and develop methodologies that will improve cost allocations.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate disagrees with SJG's comments. As previously noted, SJG's cost allocation methods are not reasonable because shared services are not appropriately segregated into cost responsibility centers and because the CAM is not adequately documented or even followed in practice. As Overland noted in the Audit Report: "While SJI's CAM is better than no documentation at all, significant additional work is necessary for it to be an effective tool in applying affiliate transaction procedures."<sup>22</sup> The Ratepayer Advocate concurs with Overland in the regard and urges the Board to establish a separate investigation into establishing a shared services division within SJG and overhauling SJI's CAM.

As for the three-factor approach, it is not strictly derived from the State of New Jersey's tax law as SJG contends in that N.J.A.C 18:7-8.3 prescribes assets, payroll, and receipts. SJI's three-factor method, on the other hand, relies on assets, payroll and gross margin. There is a significant difference between a company's receipts and its gross margin. If the three-factor approach is intended to measure total enterprise activity using different measures, it is not appropriate to reduce one of the measures by operating costs or by any other means.

The Ratepayer Advocate disagrees with Overland that a three-factor approach, or any other broad measure of enterprise activity, is not an appropriate attributable



cost basis. Some level of corporate governance or other shared services costs exist merely due to the fact that separate corporate entities mutually exist. These are precisely the types of joint costs that are susceptible to allocation on the basis of broad measures of enterprise activity or on individual contribution to the consolidated being. Contrary to Overland's recommendation, it is not appropriate to allocate these types of joint costs in proportion to the assignment of direct costs. These joint costs are unrelated to directly assigned shared services costs. Therefore, allocating these joint costs on the basis of directly assigned cost would not result in an appropriate cost basis. This is precisely result that Overland was trying to avoid by ruling out a three-factor approach.

The Ratepayer Advocate is not suggesting, at this point, that it knows how all shared service costs should be allocated. That determination should be made after careful review is made of the cost responsibility centers that the Ratepayer Advocate and Overland recommend and in conjunction with a comprehensive review of SJI's CAM. It should be noted that other New Jersey utilities have either pending or recently approved service company agreements which specify common and joint cost allocation procedures. Much can be learned from information that has already been obtained in connection with the Board's reviews of previous service company agreements involving New Jersey utilities. Therefore, the Ratepayer Advocate recommends that the Board should specify cost allocation procedures for the Company.

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<sup>22</sup> Audit Report, page 2-10.

***Overland's Recommendation***

- 2. Make necessary adjustments to all cost allocations affected by the organizational misalignment of shared corporate services.**

***SJG's Response***

SJG disagrees that there is an organizational misalignment of shared corporate services. SJG proposes to demonstrate through its cost allocation procedures that the shared corporate services' unallocated costs are allocated to affiliates in proportion to the costs directly assigned or allocated on an attributable basis.

***Ratepayer Advocate's Comments***

For the reasons previously stated, the Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted.

**C. South Jersey Gas Appliance Service Business**

***Overland's Recommendation***

- 1. Track assets and costs as specifically identified in the Affiliate Standards for all affiliates and related competitive business segments.**

***SJG's Response***

SJG agrees to track ABS assets and costs as part of the accounting for the new ASB. SJG believes there is little point in restructuring the ASB accounting within utility records, as it is the Company's plan to functionally divest the ASB from the utility. SJG's intent is to dedicate its efforts on the separate ASB accounting system and improve upon record keeping methods.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted.

***Overland's Recommendation***

- 2. Prohibit appliance service technicians from performing utility work and prohibit utility technicians from performing appliance repair except in cases of emergency.**

***SJG's Response***

SJG disagrees with this recommendation. The Company believes that the advantages to the utility from allowing the workforce to do both utility and ASB work outweigh any potential competitive advantages to ASB.

SJG proposes that this recommendation be deferred to the negotiations in settlement of the Company's Petition seeking Board authority to transfer the ASB to a separate company.

***Ratepayer Advocate's Comments***

The Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted. Certainly, in emergency situations involving SJG where assistance is needed, qualified technicians from the ASB should be allowed to assist SJG. This is similar to the mutual aid that is provided by neighboring electric utilities in times of need.

Because SJG is not willing to make its technicians available to competitors of the ASB on the same terms as it does with the ASB, such employee sharing should not be permitted. To do so would confer onto the ASB the very type of competitive advantage that the Affiliate Standards are designed to eliminate.

SJG has not presented a compelling argument for why it is necessary for utility workers to augment the workforce of the ASB. Absent such a showing, SJG's workers should be prohibited from working on ASB matters.

***Overland's Recommendation***

- 3. Prohibit the ASB from using the utility's database from future targeted marketing.**

***SJG's Response***

SJG agrees with this recommendation with modification. SJG disagrees that its former practices in this regard constitute violations of the Affiliate Standards. However, going forward continued use of the utility's database by the ASB following the ASB's spin-off would constitute a prohibited activity under the Affiliate Standards. Therefore, if the recommendation were amended to read "At a minimum, the ASB should be prohibited from carrying on this action after the Petition to Transfer is approved," SJG would agree with this recommendation.

***Ratepayer Advocate's Response***

The Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted.

**D. Millennium Account Services LLC**

***Overland's Recommendation***

- 1. Modify the agreement between Millennium and SJG to price meter reading services to recover no more than Millennium's fully allocated costs, including a regulated return on SJI's investment.**

***SJG's Response***

SJG disagrees with this recommendation. It is SJG's position that Millennium is not a RCBS. Further, it is SJG's position that prices charged by Millennium to SJG should not be subject to review by the BPU as the BPU's authority and jurisdiction does not extend to Millennium.

***Ratepayer Advocate's Comments***

For reasons previously stated, the Ratepayer Advocate agrees with Overland's recommendation and strongly urges the Board that it be adopted.

***Overland's Recommendation***

- 2. Delete provisions in the Meter Reading Service Agreement dated December 21, 2001 between SJG and Millennium, which permit Millennium to compel SJG to take ownership of certain meter reading equipment.**

***SJG's Response***

SJG disagrees with this recommendation. Its position is that the negotiations between Millennium and SJG over the contract in question were at arms-length. If the Board were to require SJG to discontinue its relationship with Millennium, without SJG's ownership of the meter reading equipment, SJG would be left with no reasonable means to read its meter for a time, until an alternate third-party vendor was identified or the service was brought-back into the utility.

***Ratepayer Advocate's Comments***

As previously stated, the Ratepayer Advocate agrees with the Liberty Audit recommendation for ACE to have ACE and SJG solicit competitive bids for meter reading services, as opposed to the Overland suggestion to simply remove the

referenced provision<sup>23</sup>. The ownership costs contained in the existing Millennium contract can be considered when evaluating the competitive bids.

### **E. South Jersey Energy Company**

#### ***Overland's Recommendation***

- 1. Prohibit any direct or indirect compensation of SJG employees for marketing, selling, or promoting SJE products and services.**

#### ***SJG's Response***

SJG agrees with this recommendation. SJG, however, disagrees with the assertion that its past occurrences were violations of the Affiliate Standards.

#### ***Ratepayer Advocate's Response***

The Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted.

### **CONCLUSION**

For the abovementioned reasons, the Ratepayer Advocate respectfully requests that the Board adopt the recommendations of Overland Consulting with which the Ratepayer Advocate agrees. Additionally, the Ratepayer Advocate urges the Board to adopt our additional recommendations, including:

- establish the requirement that there are no overlapping directors and/or officers between SJG and SJRG;
- establish the requirement that there are no overlapping directors and/or officers between SJG and Millenium;
- require a specific deadline for SJG to provide its initial Compliance Report;

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<sup>23</sup> Audit Report 1-13.

- require specific cost allocation procedures for the Company in order to appropriately segregate cost responsibility;
- formalize a shared services department within SGJ;
- overhaul and update the SJI CAM to reflect the new accounting system and more formalized shared services department; and
- require SJG to solicit competitive bids for meter reading services. In the alternative, restrict Millennium to a cost of service based transfer price for meter service.

Respectfully submitted,

Seema M. Singh, Esq.  
Ratepayer Advocate

By: \_\_\_\_\_  
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Commissioner Frederick F. Butler, via hand delivery  
Commissioner Connie O. Hughes, via hand delivery  
Commissioner Carol J. Murphy, via hand delivery  
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